China further clarifies tax rules on representative offices

Rules and regulations are changing so rapidly in China that taxpayers are having difficulty in keeping up and ensuring compliance with the new developments. This is evidenced by a radical change of taxation of Representative Offices (ROs), with the issuance of the new circular [Guo Shui Han (2004) No. 568] that reinstated the ability for ROs of principal suppliers to apply for tax exemption. Below is an overview of the tax treatment of representative offices in China.

The State Administration of Taxation (SAT) first issued a circular Guo Shui Fa (1996) No. 165 to define the tax liability of ROs, followed by another tax circular [Guoshuifa (2003) No. 28] to re-define the taxability of various types of ROs and the applicable tax bases. The circular 28 made a big change by including ROs of principal suppliers into the tax net under a cost-plus taxation method. In a dramatic change, the new Circular 568 re-opened the tax exemption opportunity for ROs of principal suppliers that provide liaison and marketing services to its head office for the sale of its own goods into China. Therefore, these ROs are no longer deemed to have provided taxable services in China under the new circular. However, there is a strict definition of principal suppliers for this purpose. A qualified principal supplier must be *solely* engaged in trading business on its own account and bearing inventory risk. The tax treatment of ROs engaging in other types of activities in China is outlined as follows.

First, ROs engaged in business advisory, legal, tax, accounting, and other professional and consultation services are mandated to calculate their applicable Chinese taxes based on the *actual* profits that they derive from services provided in China. These ROs are also obliged to keep a complete set of accounting books and business records in China in order to ascertain the actual profits for Chinese tax filing purposes. As ROs of this type previously determined their revenue on a cost-plus basis, they are now required to change their tax-filing basis as from 1 July 2003.

Second, ROs engaged in agency or trading services (e.g., advertising, tourism and general trading and distribution) shall continue reporting Chinese taxes by applying the cost-plus method to determine taxable revenue, as long as they do not directly conclude a contract with the service receiver and service charges are collected by the head office. These ROs are deemed to have derived taxable revenue based on grossing up RO costs and expenses by 15 per cent. Eligible costs that can be included in the calculation of the 'total expenses' of an RO include the remuneration paid to RO staff, telecommunication expenses, rental expenses, travelling and entertainment expenses, and costs and freight charges for purchases of sample goods in China for its head office.

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Third, ROs that render other taxable activities in China should pay Chinese taxes on the actual revenue generated, including amounts received by the head office that are attributable to them. If an RO does not earn any taxable income from services performed in China during the entire calendar year, it will be required to submit an annual activity report to the competent tax authorities within one month of the year-end date.

Fourth, ROs of principal manufacturers remain exempt from Chinese taxes on the condition that the ROs do not perform any activities other than those of a preparatory and supplementary nature in connection with the manufacture and sale of goods to China by the principal manufacturers.

Finally, where the head office is a government body or non-profit-making organisation, the activities carried out by the RO are tax-exempt. Notwithstanding the tax exemption being obtained, the RO is still obliged to submit its annual activity report to the competent tax authorities within one month after the year-end.

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